



STEP UP AND ACE THE CFA® EXAMS

Follows CFA Institute Prep Provider Guidelines

Level III

Behavioral Finance Investment Processes

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6. How Behavioral Factors Affect Committee Decision Making
7. How Behavioral Finance Influences Market Behavior

1. Introduction

- Behavioral finance challenges assumption that individuals act rationally
- Investor classification based on behavioral characteristics
- Behavioral factors impact...
 - Adviser-client relationships
 - Portfolio construction
 - Committee decision making
 - Market behavior

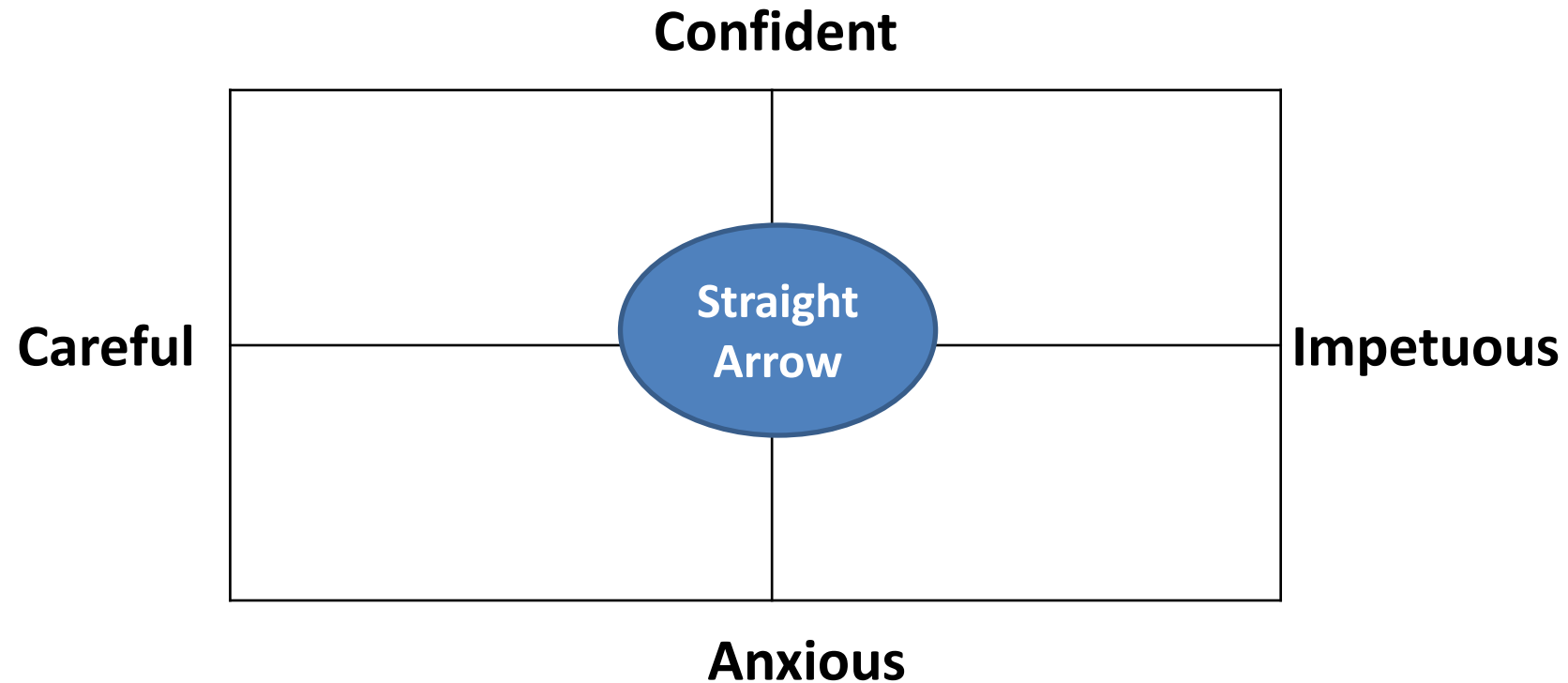
2. The Uses and Limitations of Classifying Investors into Types

Psychographic Profile → Behavior

Exhibit 1

BB&K Model

**Bailard,
Biehl
and
Kieser**



Exercise: draw model and identify where you fit 😊

Exhibit 2

- Adventurer
- Celebrity

Exhibit 2

- Individualist
- Guardian
- Straight Arrow

Behavioral Alpha Approach

A top-down approach to bias-identification

1. Interview client
 - a. Identify active or passive traits Read the 9 questions
 - b. Determine risk tolerance
2. Plot investor on active/passive scale and risk tolerance scale Exhibit 3
3. Test for behavioral biases Exhibit 4
4. Classify investor into a behavioral investment type

Exhibit 4: Biases Associated with Each Behavioral Investor Type

General Type

Passive

Active

Risk Tolerance

Low

High

Investment Style				
Bias Type				
BIT				
Emotional Biases				
Cognitive Biases				

Exhibit 5: Behavioral Investor Type Diagnostic Process

Passive Preserver (PP)

Emphasis on financial security and preserving wealth

Focus on taking care of future generations

Some are 'worriers' → slow to change

What are the common biases?

Advising PPs:

Difficult to advise because they are driven by emotion

Focus on what money will accomplish

Friendly Follower (FF)

Want to be in latest most popular investments

Often overestimate risk tolerance

What are the common biases?

Advising FFs:

Mainly cognitive biases hence education is effective

Encourage FFs to understand implications of investment options

Independent Individualist (II)

Strong willed, Independent

Enjoy investing

What are the biases?

Advising IIs:

Listen to advise when presented in a way that respects their intelligence

Regular educational sessions

Active Accumulator (AA)

Most aggressive behavioral investor type

Entrepreneurial , quick decision makers

High portfolio turnover

What are the biases?

Hands-on

Advising AAs:

Advisers need to prove to client that they have ability to make wise, objective and long term decisions

2.2 Limitations of Classifying Investors

1. Exhibit both cognitive and emotional biases
2. Exhibit characteristics of multiple investor types
3. Behavioral changes
4. Unique treatment
5. Irrational and unpredictable

3. How Behavioral Factors Affect Client-Adviser Relations

Aspect of Client-Adviser Relationship	Behavioral Considerations
Formulating Financial Goals	
Maintaining a Consistent Approach	
Investing as the Client Expects	
Ensuring Mutual Benefits	

Limitations of Traditional Risk Tolerance Questionnaires

Generally firms require advisers to use a standard tolerance questionnaire

Recognize that these questionnaires have limitations:

Ignore behavioral biases

How are questions framed

How are questions interpreted

4. How Behavioral Factors Affect Portfolio Construction

Inertia and Default

Response: Target Date Fund [Read Example 1](#)

Naïve Diversification

Simple heuristics

Framing bias

$1/n$ diversification

Company Stock: Investing in the Familiar

Familiarity and overconfidence effects

Naïve extrapolation of past returns

Framing and status quo effect of matching contributions

Loyalty effects

Financial incentives

Excessive Trading

Home Bias

Behavioral Portfolio Theory

5. Behavioral Finance and Analyst Forecasts

Overconfidence in Forecasting Skills

Illusion of knowledge bias

Self attribution bias

Representativeness

Availability bias

Hindsight bias

Example 2



Remedial Actions:

Prompt and accurate feedback

Structure that rewards accuracy

Learn to use Bayes' Formula... properly

Example 3

Influence of Company's Management on Analysis

What information is presented

How is the information presented



External Analysts

Faming Bias (see Exhibit 9)

Anchoring and Adjustment Bias → Analysis influence by initial default position or anchor

Availability Bias → Greater importance to more easily available information

Remedial Action: Disciplined and Systematic Approach

Analyst Biases in Conducting Research

Excessive unstructured information → **Illusion of knowledge** → **Overconfidence**



Representativeness Bias: Analyst estimates probability of forecast based on how much outcome resembles available data

Confirmation Bias

Gamblers' Fallacy: analysts wrongly project reversal to mean in a give time period

Example 4

“stock market will decline in the near future and then rise...”

Conjunction fallacy

Fact: probability of two independent happening is always less than probability of either event

Remedial Actions for Analyst Biases in Conducting Research

Focus on objective data

Systematic and structured approach

Follow Standard V: Investments Analysis, Recommendations and Actions

Seek contrary facts and opinions

Prompt feedback

Documentation and record retention

6. How Behavioral Factors Affect Committee Decision Making

Social Proof Bias: Individuals biased to follow beliefs of a group

Group decision → **Overconfidence Bias**

Investment Committee Dynamics

What happens to nail that sticks out?

Committees do not learn from experience

Solution

Diversity in skills, experience and culture

Respect for different views

Collect individual views before meeting

7. How Behavioral Finance Influences Market Behavior

Markets are generally efficient but behavioral biases can lead to market anomalies

7.1 Defining Market Anomalies

7.2 Momentum

7.3 Bubbles and Crashes

7.4 Value and Growth

7.1 Defining Market Anomalies

Anomalies are apparent deviations from efficient market hypothesis

Possible explanations

- Shortcoming of underlying asset pricing model
- Small sample
- Survivorship bias
- Data mining bias
- Temporary disequilibrium behavior

7.2 Momentum

Momentum or trending effect: future price behavior correlates with recent past behavior

Correlation is positive in the short-term (one-two years)

Negative in long-term (two-five years)

Herding

Anchoring to purchase price → Short-term under-reaction

Availability bias → Recency effect

Hindsight bias → Regret → Trend-chasing effect

Loss aversion → Hold on to losers longer than necessary → Disposition effect

7.3 Bubbles and Crashes

Definition: Periods of unusual positive or negative asset returns

Technology bubble of 1999-2000 Residential property boom of 2005-2007

Bubble

“Irrational Exuberance”

Rational and behavioral finance explanations for asset bubbles (Read Exhibit 12)

Overconfidence → Overtrading, under-estimation of risk ← Confirmation and Self Attribution Bias

Illusion of Knowledge

Crash

As bubble unwinds → Disposition effect → Initial under-reaction followed by capitulation

7.4 Value and Growth

Value stocks outperform growth stocks over long periods

Review learning objectives

Examples

Practice Problems